No. 22041

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

ERNEST H. WEIGMAN and BEULA D. WEIGMAN,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

ON PETITION FOR REVIEW OF THE DECISION OF THE

TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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I N D E X

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OPINION BELOW

The findings of fact and opinion of the Tax Court (I-R. 29-46), are reported at 47 T.C. 596.

JURISDICTION

The petition for review (I-R. 53-56) involves deficiencies in federal income tax for the taxable years 1958 through 1960 in the amount of $27,374.63. On April 15, 1964, the Commissioner of Internal Revenue mailed to the taxpayers a notice of deficiency asserting deficiencies in tax for the years 1958 through 1960 totaling $27,374.63. (I-R. 8-12.) Within ninety days thereafter,

on July 13, 1964, the taxpayers mailed[1/] a petition to the Tax Court for a redetermination of those deficiencies under the provisions of Section 6213 of the Internal Revenue Code of 1954. (I-R. 1-12.) The decision of the Tax Court was entered on March 20, 1967. (I-R. 52.) The case is brought to this Court by a petition for review filed June 15, 1967 (I-R. 53-56), within the three-month period prescribed in Section 7483 of the Internal Revenue Code of 1954. Jurisdiction is conferred on this Court by Section 7482 of that Code.

QUESTIONS PRESENTED

1. Whether the Tax Court erred in holding that the Bird Cage restaurant was operated by a bona fide, viable corporation rather than as a sole proprietorship, as claimed by taxpayers, so that any loss sustained by the business could be deducted only by the corporation and not by its shareholders.

2. Whether the Tax Court erred in holding that taxpayers' loans to a solely-owned corporation were nonbusiness bad debts as defined by Section 166(d) of the Code and, therefore, could be deducted in the year they became worthless only as a short-term capital loss.

1/ Under Section 7502 of the Internal Revenue Code of 1954, timely mailing is treated as timely filing.

STATUTES INVOLVED

Internal Revenue Code of 1954:

SEC. 165. LOSSES.

(a) General Rule.--There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

* * *

(c) Limitation on Losses of Individuals.--In the case of an individual, the deduction under subsection (a) shall be limited to--

(1) losses incurred in a trade or business;

* * *

(26 U.S.C. 1964 ed., Sec. 165.)

SEC. 166. BAD DEBTS.

(a) General Rule.--

(1) Wholly worthless debts.--There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

* * *

(d) Nonbusiness Debts.--

(1) General rule.--In the case of a taxpayer other than a corporation--

(A) subsections (a) and (c) shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months.

(2) Nonbusiness debt defined.--For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than--

(A) [as amended by Sec. 8, Technical Amendments Act of 1958, P.L. 85-866, 72 Stat. 1606] a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

* * *

(26 U.S.C. 1964 ed., Sec. 166.)

STATEMENT

The facts, as found by the Tax Court (I-R. 30-41), some of which were stipulated (I-R. 23-27), are not in dispute and are substantially as follows:

Taxpayers, Ernest H. Weigman and Beula D. Weigman, reside at 2626 Camino Principal, Tucson, Arizona. (I-R. 31.)

Ernest H. Weigman (Weigman) lived in Chicago, Illinois, until September 26, 1965, when he moved to Tucson, Arizona. While in Chicago, and from 1942, Weigman owned and operated a corporation called Champion Railway Specialties Corporation, which was engaged in the sale of railway supplies. Among other things, that corporation sold mechanical supplies and parts used on railroad freight cars and locomotives such as handbrakes, draft gears, running boards, mats, belts, and miscellaneous items. (I-R. 31.)

Upon leaving Chicago for Tucson, Weigman liquidated the railway supply corporation but retained personally some of the railroad accounts. (I-R. 31.)

As shown in his tax returns for the years in issue, Weigman's activities with respect to the railway supply business after moving to Tucson were of a steadily diminishing nature and were carried out under the name of E. H. Weigman Railway Supply Company, a sole proprietorship located at 2626 Camino Principal, Tucson, Arizona. Thi address is the same as that shown as the principal residence of taxpayers. (I-R. 31.)

Weigman's gross and net profits from his railway supply activities, as shown in his income tax returns for 1958 through 1961 (I-R. 31), were as follows (I-R. 32):

Year	Gross Profit	Net Profit
1958	$23,005.86	$9,422.61
1959	10,781.12	3,869.40
1960	8,122.73	3,278.87
1961	3,620.05	276.34

Weigman's income tax returns for the years 1958 through 1961 show his occupation as "salesman." (I-R. 32.)

The Bird Cage Restaurant and Cocktail Lounge, Inc. (also referred to as Bird Cage), was incorporated in Arizona in June 1960. It began business on August 20, 1960, in a leased building located at 4915 North Scottsdale Road in Scottsdale, Arizona. (I-R. 32.)

Gerald O'Dell, a nephew of Beula Weigman, first brought the restaurant, known as the Bird Cage, to the attention of the Weigmans and invited them to invest in the corporation. At that time, Gerald O'Dell and William Bird were the only subscribing stockholders of the corporation. Bird was the operating manager of the restaurant. (I-R. 32.)

Taxpayers purchased a one-third share of the stock of the Bird Cage after it had commenced business. On some undisclosed date after the Weigmans purchased stock in the Bird Cage, Weigman became president of the corporation. (I-R. 32.)

The financing plan whereby taxpayers became part owners of the corporation called for a stock investment of $5,000 each by Bird, O'Dell, and Weigman plus a loan of $10,000 each to the corporation. Both Weigman and Bird made their investments and loans, but O'Dell failed to make either his investment or his loan. (I-R. 32.)

Under the agreement whereby taxpayers became stockholders, it was expected that O'Dell would share in the responsibilities of running the business. However, he had other interests and was often away from the Bird Cage. Upon being challenged on this point, he expressed a desire to get out the corporation and offered his stock for sale, and Weigman agreed to purchase it. (I-R. 33.)

On or about October 6, 1960, Weigman acquired O'Dell's interest, paying $5,000 to cover O'Dell's stock subscription and making the required $10,000 loan. This left Bird, Weigman, and their respective wives as sole shareholders in the corporation. Although taxpayers

were not familiar with the restaurant business, they came in, surveyed and studied the operation and, by late fall of 1960, drew the conclusion that it was not being operated as it should. (I-R. 33.

Taxpayers offered suggestions for changes in operating methods and criticized certain procedures which had been instituted by Bird. As a result, Bird became indignant and offered to step out of the corporation entirely and sell his stock to the taxpayers. They accepted and became the sole stockholders of the corporation around the first of March 1961. On February 5, 1961, taxpayers made a $500 down payment in cancellation of Bird's manager contract. (I-R. 33.)

The effect of the acquisition by taxpayers of O'Dell's and subsequently Bird's interest in the Bird Cage was the elimination of one shareholder who had failed to live up to the terms of the original agreement and, later, the remaining shareholders with whom taxpayers were at variance with respect to operating methods. From that time until the restaurant failed in late 1961, taxpayers personally devoted much of their time and efforts to the operation of the restaurant in an attempt to make it a successful going business. No meetings of directors or stockholders of the Bird Cage Restaurant and Cocktail Lounge, Inc., were thereafter held, or any purported meetings of stockholders or directors. (I-R. 33-34.)

Sally Graves owned the building occupied by the Bird Cage. She would not lease the premises to a corporation, but desired the individuals in control of the business to be personally obligated. Initially, William Bird had been the lessee. However, on

March 1, 1961, a new lease was executed by taxpayers in their personal capacities. The lease was for a period of 10 years and provided for a base monthly rental of $1,000, with a bonus payment when the prior month's sales exceeded the base rental. Based on a $1,000 monthly rental for the 10-year period, taxpayers' minimum aggregate personal liability under the terms of the lease, if fully executed, was approximately $120,000. (I-R. 34.)

Shortly after the execution of the lease, Jack Gausner was employed to manage the restaurant. Gausner was responsible to Weigman in the performance of his duties. (I-R. 34.)

At or about this time a number of creditors made demand for payment, and Weigman placed additional funds into the business. Weigman also advanced various sums to establish working capital for the operation of the business. (I-R. 35.)

At about the time Gausner became manager, taxpayers assisted him and gained experience in the restaurant operation. Weigman worked closely with Gausner in the over-all operation of the business, but with particular attention to handling the accounts, dealing with creditors and the assumption of a good measure of responsibility with respect to the purchasing of supplies and the employment of operating personnel. (I-R. 35.)

After Gausner became manager, the business continued to lose money and it became apparent to taxpayers that he could not meet their expectations with respect to the operation of the restaurant. (I-R. 35.)

At some undetermined time early in 1961, Gausner's employment was terminated. A sublease was later entered into by the Bird Cage Corporation with Sun Valley Management Company, Inc., to manage the business. Sun Valley was in the business of subleasing different businesses and operating them under special contracts. The agreement was for a period of 5 years and provided for the use by Sun Valley of the Bird Cage premises for the stated period and contained rental and other provisions, many of which were substantially the same as those contained in the lease between taxpayers and Sally Graves, the owner of the premises. Jerry Englis was the operating head of the Sun Valley Management Company, Inc., and also assumed management of the Bird Cage under the agreement. He was actively assisted in its management by taxpayers. (I-R. 35-36.)

Sometime in July, while the agreement between the Bird Cage and Sun Valley Management Company, Inc., was still in effect, taxpayers assigned the lease of March 1, 1961, between themselves and Sally Graves to the Bird Cage. The assignment was approved in the same instrument by Sally Graves, the lessor, with the understanding that the approval did not release taxpayers from any of their personal obligations under the lease. (I-R. 36.)

The Sun Valley Management Company, Inc., also failed in its operation of the business and defaulted on the sublease, and the agreement with that corporation was terminated. Simultaneously therewith or shortly thereafter, an arrangement was entered into by the Weigmans with Shirley Girard which was in substantial respects similar to the prior arrangement with the Sun Valley Management Company. As in their prior arrangements, taxpayers assisted in the operation of the business. (I-R. 36.)

The arrangement with Girard also proved unsuccessful. Taxpayers, through their corporation, acquired the services of Ray S. Jackson, a local restaurant manager of high reputation, sometime in October of 1961. Pursuant to Jackson's advice to change the name of the establishment, there was an assignment of the lease by the Bird Cage corporation to Jackson, doing business as Petite Cafe, Inc., on November 1, 1961. (I-R. 36.) Among other things, the assignment provided that Jackson would perform all the terms, covenants, and conditions of the lease with Sally Graves, including the payment of rent, and holding the assignor, as well as taxpayers, harmless from any and all obligations and duties enuring to it and them under that lease. Again, taxpayers assisted in the operation of the business. (I-R. 37.)

Jackson also defaulted on the sublease, and any further attempt to operate the business was suspended. The business was closed and disposed of sometime after January of 1962. (I-R. 37.)

A schedule entitled "E. H. Weigman and Beula Dell Weigman Personal Loans to Bird Cage Corp" was prepared by Ernest Weigman subsequent to the filing of taxpayers's joint federal income tax return for 1961 and prior to the filing of the Tax Court petition in proceeding. It shows loans made to the corporation as follows (I-R. 37-38):

Date		Amount
July 1, 1960		$10,000
October 6, 1960		10,000
November 23, 1960		10,000
February 5, 1961	Partial payment to William Bird to cancel manager's contract	500
February 7, 1961	Repay First National Bank loan	6,000
February 8, 1961	Rent in arrears	2,000
February 15, 1961	March rent	1,800
March 2, 1961	Liquor license	650
March 2, 1961	Payment to William Bird to cancel manager's contract	7,000
March 3, 1961	For operating expense and obligations due and past due	15,000
March 10, 1961	do	20,000
March 25, 1961	do	10,000
April 6, 1961	do	18,000
April 24, 1961	do	2,000
April 26, 1961	do	1,000
May 15, 1961	do	500
May 22, 1961	do	2,000
June 1, 1961	do	12,000
June 7, 1961	do	1,000
June 12, 1961	do	1,000
July 1, 1961	do	1,000
August 1, 1961	do	2,100
August 10, 1961	do	1,700
September 1, 1961	do	2,000
September 30, 1961	do	1,000
October 2, 1961	do	400
October 18, 1961	do	500
October 31, 1961	do	125
November 6, 1961	do	3,000

Date		Amount
November 6, 1961	do	$2,000
November 10, 1961	do	4,500
November 6, 1961	do	2,000
November 7, 1961	do	2,500
November 25, 1961	do	500
December 1, 1961	do	550
December 29, 1961	do	500
	Total loans during 1960 and 1961	$154,825
January 3, 1962	For operating expense and obligations due and past due	1,000
January 3, 1962	do	400
January 3, 1962	do	100
	Grand total 1960, 1961 and 1962	$156,325

The corporate bank account was used to receive funds from Weigman and used to pay out funds. All loans to the Bird Cage corporation were evidenced by cancelled checks and interest-bearing notes. (I-R. 38.)

The Bird Cage filed a corporation income tax return for the fiscal year beginning July 1, 1960, and ending June 30, 1961, with the District Director of Internal Revenue at Phoenix, Arizona. This return was signed on August 29, 1961, by E. H. Weigman in his capacity as president of the corporation. The corporate return shows "Loans from stockholders" outstanding as of June 30, 1961, in the amount of $122,900. The corporate return also shows, inter alia, the following (I-R. 39):

Sales	$187,531.69
Salaries and wages	6,045.49
Rents	22,696.33
Taxes	4,671.17
Depreciation on various property	10,771.12
Music and Entertainment	15,633.46
Insurance	3,811.31
Legal and audit	7,487.18
Merchandise purchased	69,549.11

The return shows a loss of $68,978.45 for the fiscal year ended June 30, 1961. (I-R. 39.)

On taxpayers' joint federal income tax return for 1961 a loss in the operation of the restaurant business was claimed in the amount of $158,669.67 as follows (I-R. 39-40):

Interest Expense

1st Natl Bank--Scottsdale	$ 965.00	
W. F. Weigman	293.32	
J. R. Weigman	900.00	
		$ 2,158.32

Travel Expense

Fares	$ 105.24	
Meals and lodging	1,060.92	
Car rent	9.78	
Total travel		$ 1,175.94
Telephone		510.41
Loss on notes		154,825.00
Total loss		$158,669.67

Taxpayers attached a Schedule C, Profit (or Loss) From Business or Profession, to their 1961 income tax return covering the wholesale railway supplies business, but none for the restaurant business. (I-R. 40.)

An application for a tentative carryback adjustment was filed on March 13, 1962, for the year 1961. A refund (exclusive of interest) was received by taxpayers around April 10, 1962, for each year, as follows (I-R. 40):

Year	Amount
1958	$21,593.31
1959	4,619.79
1960	1,161.53

Weigman received no salary and took no compensation from the Bird Cage operation in 1960 or 1961. He was not an employee of the corporation. (I-R. 40.)

In his notice of deficiency the Commissioner disallowed the $158,669.67 deduction claimed as a loss sustained in the operation of the restaurant business in 1961 on the ground that taxpayers had not established that they were entitled to such a deduction in that year as a result of advances made to the business. (I-R. 40.)

In holding for the Commissioner, the Tax Court found:

Taxpayers did not operate the Bird Cage as a sole proprietorship in 1961. The Bird Cage was a bona fide, viable corporation in 1961 which was engaged in carrying on business activity. (I-R. 41.)

The loans made to Bird Cage in 1961 by taxpayers were not related to a trade or business of being an employee. Ernest Weigman had no trade or business of lending money or of financing corporations. (I-R. 41.)

The amount of $158,669.67, representing loans to the Bird Cage corporation, did not constitute an ordinary business loss or a business bad debt, in whole or in part, to taxpayers in 1961. (I-R. 41.)

SUMMARY OF ARGUMENT

Taxpayers seek to deduct monies advanced by them to a restaurant business as either a loss incurred in a trade or business (Section 165) or as a business bad debt (Section 166). The Tax Court sustained the Commissioner's determination that taxpayers are entitled only to a nonbusiness bad debt deduction.

Taxpayers contend that although the restaurant business was originally operated by a corporation, this ceased to be true when they obtained 100 percent ownership of the corporate stock. Thereafter, they submit, they ignored the corporate form and conducted the business as a sole proprietorship and therefore, the losses sustained are deductible as a loss incurred in this trade or business. Nothing in the record, however, indicates that taxpayers ignored the corporate form; rather, the record indicates the contrary.

The business continued to be operated in the corporate form. The corporate bank account was retained, and all receipts and disbursements passed through it. Every time taxpayers advanced funds to the business, they termed it a loan, and the advances were evidenced by interest-bearing notes issued by the corporation. The corporation acquired the lease of the business premises and in turn, subleased the premises to another company. The corporation filed a corporate tax return which was signed by one of the taxpayers in his capacity as president. Finally, on their individual tax return, taxpayers did not indicate that they were in the restaurant business nor did they attach a Schedule C (Profit or Loss from Business or Profession).

Taxpayers' rely on the fact that they held no corporate meetings nor elections, but this is a common occurrence in closely held corporations and does not indicate that a business is not being conducted in corporate form. As for taxpayers' major evidentiary point, namely, that they and not the corporation were personally liable on the lease, this is readily explained by the fact that the lessor would not lease the premises to a corporation but only to the individual or individuals in control of the business.

The record therefore amply supports the Tax Court's finding that the restaurant was operated by a bona fide, viable corporation and it, the business, was not operated by taxpayers as a sole proprietorship.

Taxpayers also appear to urge that if the business was conducted by the corporation, the loans that they made to it, which were not repaid, are deductible as a business rather than a nonbusiness bad debt. Section 166 of the Internal Revenue Code provides that in order to obtain a business bad debt deduction, an individual must show that the debt was incurred by him in his trade or business. The Supreme Court has held that for the purposes of this section the furnishing of services and advice to a wholly owned corporation is not a business. To be eligible for deduction, a taxpayer must show that the loan was made in either: the business of loaning money, the business of promoting and financing corporations, taxpayer's business of working as an employee of the debtor, or in some other commercial relationship. Taxpayers do not contend that they fit within any of these tests--they only contend they were financing their restaurant.

Accordingly, the loans were not incurred in taxpayers' trade or business and they are entitled only to deduct the losses as a short-term nonbusiness bad debt.

ARGUMENT

I

THE TAX COURT WAS CORRECT IN FINDING THAT THE BUSINESS OF BIRD CAGE RESTAURANT WAS CONDUCTED BY TAXPAYERS' WHOLLY-OWNED, BONA FIDE CORPORATION, AND NOT BY THE TAXPAYERS AS AN INDIVIDUAL PROPRIETORSHIP

In order for an individual to obtain a loss deduction under Section 165(c)(1) of the Internal Revenue Code of 1954, he must show that the loss was incurred in his trade or business. In the instant case, taxpayers contend that they operated a restaurant as a sole proprietorship and therefore, the losses sustained by the restaurant are deductible on their individual income tax return. However, the Tax Court found that the restaurant was operated by a corporation and therefore, the losses could be deducted only by that taxpayer. As will be shown, the Tax Court was correct.

The test as to whether a corporation is to be recognized for purposes of the income tax law was established by the Supreme Court in Moline Properties v. Commissioner, 319 U.S. 436. The test is whether the organization of the corporation is the equivalent of business activity (thereby preventing sham transactions) or is followed by the carrying on of business by the corporation. See also National Carbide Corp. v. Commissioner, 336 U.S. 422. This Court expressed the rule in O'Neill v. Commissioner, 271 F. 2d 44, 49:

> The chief complaint of the taxpayer * * * is that the Tax Court should have disregarded the corporate status of Eagle Timber. The taxpayer argues that

> since he was the owner of the corporation, we should entirely disregard the corporation and adopt his contentions. As a general rule, a corporation is to be treated as an entity separate from the individuals who own it. * * * An exception is recognized and the corporate structure may be disregarded where (1) the purpose of its creation was not a business purpose, and (2) the creation was not followed by any business activity. * * *
>
> On the other hand, where the corporation is created for a business activity or the creation is followed by business activity, the corporation must be recognized as a separate entity. * * *

Taxpayers do not dispute that the Bird Cage was formed with a business purpose and, in fact, even agree that following the incorporation, the corporation carried on the business activity of operating a restaurant and cocktail lounge. (I-R. 24.) However, they claim (Br. 9) that afterwards--that is, following their becoming 100 percent owners of the corporate stock--the corporation ceased to operate the restaurant and thereafter the restaurant was operated by them as a sole proprietorship.

Although taxpayers contend they ignored the corporate structure, the evidence shows that time after time they worked through the corporate form. Thus, they not only retained the corporate bank account, but all payments and receipts of the restaurant passed through it. (I-R. 44.) The loans (advances) made by taxpayers to the restaurant were evidenced by interest-bearing notes of the corporation (I-R. 44), which indicates that taxpayers realized that they were transacting business with an entity apart from themselves. The corporation on two separate occasions entered into a sub-lease: once with Sun Valley Management Co. (although at the time, Bird Cage

was not the lessee of the premises, this matter was rectified shortly thereafter when taxpayer assigned the lease to the corporation) and later, with Ray S. Jackson.

Also, taxpayers filed a corporate return for the fiscal year ended June 30, 1961, which was signed by Weigman in his capacity as president of the corporation. (I-R. 39.) The corporate return indicated that the $122,900 which taxpayers had put into the business were "Loans from stockholders". (I-R. 39.) And on their own income tax return for 1961, taxpayers gave no indication (other than claimin a loss from the restaurant operation) that they believed the restaurant to be their trade or business. Weigman listed his occupation as "salesman." (I-R. 32.) More importantly, although taxpayers attached a Schedule C, Profit (or Loss) From Business or Profession, to this return for the wholesale railing supplies busines, they did not attach such a schedule for the restaurant business. (I-R. 40.) None of these facts are disputed by taxpayers, yet, nonetheless, they make no effort to overcome their significance. Indeed, they quite candidly state (Br. 19-20) "The use of the corporate bank account (which the Weigmans allege was continued for convenience), and the filing of tax returns for 1961 cannot be ignored" (Br. 19-20).

Taxpayers of course point to those facts which they contend show that they were ignoring the corporate existence. Their major contention (Br. 19) is that they, and not the corporation, leased the premises occupied by Bird Cage. But as the Tax Court found (I-R. 34) (a fact which taxpayers do not contest)--

> Sally Graves owned the building occupied by the Bird Cage. She would not lease the premises to a corporation, but desired the individual or individuals in control of the business to be personally obligated.

Thus, the reason taxpayers entered into the lease personally is not because they were operating a sole proprietorship but because the lessor would not do business with a corporation. This is clearly shown by the fact that even during the period taxpayers agree the corporation operated the business, the lessee was an individual (William Bird), and not the corporation. Accordingly, little, if any, weight can be attached to the fact that taxpayers were personally liable as lessees once they obtained full ownership of the corporation.

As was noted above, taxpayers later assigned the lease to the corporation. No explanation was given by taxpayers why they made the assignment, but it appears that they realized, or were advised, that the prior sublease agreement between Bird Cage Corporation and Sun Valley would not be binding on Sun Valley if Bird Cage Corporation had no right to lease the premises. Whether this be the reason or not the assignment of the lease was later entered into by taxpayers and the corporation, the assignment clearly indicates that taxpayers were hardly ignoring the existence of the corporation. And taxpayers cannot claim that in this instance they were acting without advice from knowledgeable persons,[2/] as they contend elsewhere (Br. 13-14), for the execution of the assignment was done in the presence of taxpayers' counsel. (II-R. 35.)

2/ Of course, taxpayer E. H. Weigman appears to have some knowledge of business affairs. He had previously owned and operated a corporation, which he liquidated, and he personally retained some of the accounts. (I-R. 31.) Therefore, taxpayers are hardly as ignorant of corporate operations as they implied in the Tax Court.

As for the other facts cited (Br. 19) by taxpayers, these are hardly persuasive that the corporate entity had been cast aside. Indeed, all of them are consistent with the actions of individuals who are the sole owners of a corporation. Thus, one would expect that taxpayers as the corporation's only shareholders would be the source of its working capital unless, of course, the corporation were operating at a profit. It is noteworthy that each advance was evidenced by an interest-bearing note, a procedure which would be absurd if taxpayers were truly putting in funds in a sole proprietorship.

The failure to adhere to corporate practices, such as elections conducting meetings, or maintaining corporate minutes, is a common occurrence in closely-held corporations, and the failure to comply with these practices does not constitute grounds for not recognizing the corporation. O'Neill v. Commissioner, supra, p. 49. As for taxpayers' "* * * continued control of the operation of the restaurant" (Br. 19)--a fact on which they place great emphasis--it is obvious that a corporation can only function through the activities of its owners and managers. In this connection, the Supreme Court in National Carbide Corp. v. Commissioner, supra, has said (pp. 431-43

> * * * that under our decisions, when a corporation carries on business activity the fact that the owner retains direction of its affairs down to the minutest detail, provides all of its assets and takes all of its profits can make no difference tax-wise. * * *
>
> * * * Undoubtedly the great majority of corporations owned by sole stockholders are "dummies" in the sense that their policies and day-to-day activities are determined not as decisions of the corporation but by their owners acting individually. * * *

Clearly, then, none of the facts which taxpayers put forth in any way indicate, much less establish, that they had cast aside the corporation and undertaken the restaurant business as their own. To the contrary, the record shows that taxpayers dealt through and with the corporation as the operator of the business and as the separate entity that it was.[4/] We submit that the Tax Court aptly summarized this case when it stated (I-R. 45):

> Weigman was an experienced businessman who knew what he was doing while he owned and controlled the Bird Cage corporation during 1961. He did not sound taps over a lifeless corporation. He did not extricate himself from the corporation. Instead, he consciously chose to continue and operate the corporation throughout most of 1961. See Omaha National Bank v. Commissioner, 183 F. 2d 899 (C.A. 8, 1950), affirming a Memorandum Opinion of this Court, which is factually similar to this case. Here the petitioner adopted the corporate form for purposes of his own. The choice of the advantages of incorporation to do business requires the acceptance of its tax disadvantages. Burnet v. Commonwealth Imp. Co., 287 U.S. 415 (1932). When the petitioner became the sole stockholder of the corporation in March 1961, he could have voluntarily dissolved

4/ Although taxpayers note (Br. 22) that the trial judge dissented from the opinion of the Tax Court, they do not urge that this constitutes reversible error. Of course, Section 7460(b) of the 1954 Code specifically provides:

> SEC. 7460. PROVISIONS OF SPECIAL APPLICATION TO DIVISIONS.
>
> * * *
>
> (b) Effect of Action by a Division.--The report of the division shall become the report of the Tax Court within 30 days after such report by the division, unless within such period the chief judge has directed that such report shall be reviewed by the Tax Court. * * *
>
> (26 U.S.C. 1964 ed., Sec. 7460.)

(continued)

the corporation pursuant to section 10-361 et seq., Arizona Revised Statutes Annotated, and started anew as a sole proprietorship. But that he did not do. Unfortunately for him, the income tax predicament in which he now finds himself was of his own making and any attempt to wish it away now is insufficient. Accordingly, any losses sustained from the operation of the restaurant business are properly attributable to the Bird Cage corporation rather than to the Weigmans.

4/ (continued)
And in Hamlin's Trust v. Commissioner, 209 F. 2d 761 (C.A. 10th), the court stated (p. 764):

> It is not urged that it was reversible error for one member of the court to conduct the hearing and another member to write the findings of fact and the opinion. The substance of the argument is that the findings of the member of the court who conducted the hearing are entitled to greater weight than are the findings of the other members who did not observe the witnesses and hear their testimony. There is no express requirement in law that the member of the Tax Court who presided at the hearing and observed the witnesses while testifying shall make the findings of fact and write the opinion of the court, and it is not reversible error for one member to conduct the hearing and another member to prepare the findings of fact and write the opinion. Halle v. Commissioner, 2 Cir., 175 F. 2d 500, certiorari denied, 338 U.S. 949, 70 S. Ct. 485, 94 L. Ed. 586. Manifestly, where the case turns upon a controverted issue of fact concerning which there is a conflict in the oral testimony, the member of the court who observed the witnesses while testifying and thus had an opportunity to appraise their credibility and determine the weight to be given to their testimony is in a better position than are other members of the court to resolve the conflict or conflicts and reach the correct determination of the ultimate fact or facts. But these generalizations are not controlling here for the reason that there was little or no substantial conflict in the evidence relating to the decisive question of fact.

In the instant case, there was no conflict in the evidence whatever.

In closing, it should be noted that the dissent urges that the majority is in error because by holding for the Commissioner, form is controlling substance. However, this case does not turn on the technical failure of taxpayers to dissolve the corporation. Rather, the entire record shows that taxpayers acted in complete conformity with the practices one would expect when a corporation is owned by one or two shareholders. The dissent does not indicate how this case is distinguishable from the ordinary case of the operation of a closely-held corporation. Stated differently, there is nothing in the record that indicates that taxpayers were acting on their own behalf and not on behalf of the corporation. Ripley v. Commissioner, 26 T.C. 1203, relied on by the dissent is not in point. There, a corporation entered into an arm's-length agreement with taxpayer that he would operate the corporation for a year, reaping all profits and sustaining all losses. The Court permitted taxpayer a loss deduction, holding that he had a business different from the business of the corporation, i.e., his business was to carry out the terms of the contract which required him to furnish personal services in carrying on the business of the corporation. The court went on to note (p. 1209):

> The items of income and expense for that period from the operation of the business of the corporation such as gross sales, cost of goods sold, wages, officers' salaries, and like items, were those of the corporation and not of the petitioner because such separate items would not represent income or expense of his business.

In the instant case, taxpayer does not claim to have a business separate from the corporation, he insists that his business was the restaurant business.

As for Kittle v. United States, decided December 14, 1966 (67-1 U.S.T.C., par. 9241), also cited by the dissent, that case was unlike the instant one for there, much of the evidence was in dispute. For example, taxpayers contended that they owned all the assets of the business, indicating the absence of corporate existence. The Government, on the other hand, contended that the corporation owned the assets. Accordingly, on the evidence, the jury could have found that the corporation did not own assets, carried on no business activity, and that the business was really a sole proprietorship.

II

THE TAX COURT WAS CORRECT IN HOLDING THAT TAXPAYERS' LOANS TO THE CORPORATION WERE NOT INCURRED IN TAXPAYERS' TRADE OR BUSINESS

For purposes of this discussion, we are assuming that taxpayers' contention here is an alternative one--namely, assuming that the restaurant was operated by the corporation then the loans (advances) made by taxpayers to the restaurant are deductible as a business bad debt. 5/

5/ The Supreme Court in Putnam v. Commissioner, 352 U.S. 82, stated that a taxpayer seeking a bad debt deduction could not urge in the alternative that he had a loss deduction. That is, if he sought a Section 166 deduction, he could only obtain relief under that provision or not at all, i.e., he could not obtain a Section 165 deduction. In that case, taxpayer urged he had a bad debt incurred in his trade or business (Section 166) but if not, then he had a loss incurred in a transaction entered into for a profit and not related to his trade or business (Section 165). Although here taxpayers rely on both sections, their argument is slightly different. They seek a Section 165 loss on the basis that their advances were made in their trade or business or in the alternative, they had a business bad debt.

Section 166(a) provides a deduction in full for worthless debts. However, Section 166(d) provides that nonbusiness bad debts shall be treated as losses on the sale of short-term capital assets. A nonbusiness bad debt is a debt other than one the loss from the worthlessness of which is incurred in the taxpayer's trade or business.[6/] Accordingly for taxpayers to obtain the business bad debt deduction that they seek, they must show that the advances were related to the conduct of a trade or business in which they were engaged. Whipple v. Commissioner, 373 U.S. 193; United States v. Keeler, 308 F. 2d 424 (C.A. 9th).

Because the business of a taxpayer is distinct from that of its shareholders (Deputy v. DuPont, 308 U.S. 489; Burnet v. Clark, 287 U.S. 410), the individual shareholder who owns a corporate enterprise and manages his investment therein, including occasional advances of money to them, is not conducting a trade or business. His return is an investor's return, and his bad debts are nonbusiness bad debts even though the corporation is involved in a trade or business. Whipple v. Commissioner, supra; Higgins v. Commissioner, 312 U.S. 212.

6/ In Putnam v. Commissioner, supra, the Supreme Court stated that the purpose for treating nonbusiness bad debts as short-term capital losses was to (pp. 91-92): (a) minimize the revenue losses attributable to the fraudulent practices of taxpayers who made gifts disguished as loans to friends and relatives and (b) to put nonbusiness investments in the form of loans on equal footing with other nonbusiness investments.

In Whipple 7/ the taxpayer had organized a number of corporations contributing to each his own initiative and energy and such financial backing as it required. The Supreme Court, sustaining the Court of Appeals for the Fifth Circuit, held that the taxpayer's activities with regard to these corporations did not constitute a separate business, so that a bad debt resulting from a loan to one of these corporations did not constitute a business bad debt. It did not matter how many corporations were involved or how extensive taxpayer's activities had been, for the only return taxpayer could have derived from these activities was that of an investor. The Court stated (p. 202):

> Devoting one's time and energies to the affairs of a corporation is not of itself, and without more, a trade or business of the persons so engaged. Though such activities may produce income, profit or gain in the form of dividends or enhancement in the value of an investment, this return is distinctive to the process of investing and is generated by the successful operation of the corporation's business as distinguished from the trade or business of the taxpayer himself. When the only return is that of an investor, the taxpayer has not satisfied his burden of demonstrating that he is engaged in a trade or business since investing is not a trade or business and the return to the taxpayer, though not from his own trade or business but from that of the corporation. 7/

7/ Whipple of course deals with bad debt losses, an issue which the dissent felt was not in issue in the instant case. (I-R. 50.) This view--that the case does not involve bad debts--explains why the dissent concluded (I-R. 50) that this case is not like the Whipple case.

In order to be eligible for a business bad debt loss, the taxpayer must show that the loan arises: (1) in the business of loaning money, or (2) in the business of promoting, financing, and managing business enterprises; Whipple v. Commissioner, supra; United States v. Keeler, supra, p. 428 or, (3) in order to protect the taxpayer's business of working as an employee of the debtor; Trent v. Commissioner, 291 F. 2d 669 (C.A. 2d), or in some other commercial relationship with the debtor that can be termed a business rather than an investment. Dorimey v. Commissioner, 26 T.C. 940 (loans to a corporation formed to insure a source of supply to taxpayer's produce business). Taxpayers here do not come within the ambit of any of these tests. Taxpayers were not in the business of lending money or financing corporations nor have they urged that they were employees of the corporation. There was no other commercial relationship with Bird Cage which would be termed a business rather than an investment. As the Tax Court concluded (I-R. 46):

> Since Weigman has not established to our satisfaction that the loans made to the Bird Cage corporation were incurred in his trade or business, it follows inexorably that the claimed bad debt was not a business bad debt and we so hold.

CONCLUSION

For the reasons stated above, the decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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FEBRUARY, 1968.

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: _____ day of _____, 1968.

_____
MARCO S. SONNENSCHEIN
Attorney